PROBLEMS

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DIRECTORATE OF
INTELLIGENCE

# Intelligence Memorandum

## *Ecuador's Continuing Export And Budget Problems*

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
January 1970

INTELLIGENCE MEMORANDUM

# Ecuador's Continuing Export And Budget Problems

## Introduction

Ecuador's export earnings declined in 1969 and are not likely to recover fully during the next several years, much less expand. In addition, the budget deficit was much larger than usual in 1969 and will be difficult to reduce in the near future. Continued economic and political troubles thus lie ahead for this chronically unstable country. The accession of a strongly nationalistic government, always a possibility, would be particularly unfortunate for economic development because petroleum exploitation -- the new hope for accelerated progress in the 1970s -- might be disrupted. This memorandum examines Ecuador's deteriorating export and budget positions and assesses their impact.

## Background

1. Although Ecuador is heavily dependent on banana exports, since 1964 it has accounted for a declining share of the world banana market. Ecuadorean banana sales rose from $17 million in 1950 (7% of world banana exports) to $90 million in 1959 (28% of world exports). During 1960-64 the country managed only a 10% gain in the value of banana exports because of falling world market prices, but its share of the world market rose to a peak of 37% owing to other producers' difficulties. As Central American production recovered during 1965-68, Ecuador's banana exports grew

*Note: This memorandum was produced solely by CIA. It was prepared by the Office of Economic Research and was coordinated with the Office of Current Intelligence.*

little, and its share of world banana trade slipped to about 25%. By 1968 the share of bananas in Ecuador's total exports had dropped to 50% compared with 60% in 1960.

2. Readjustments in the world banana trade slowed the growth of Ecuador's export earnings during 1961-68 in spite of gains from cocoa, coffee, and sugar sales. As a result, total exports increased an average of about 4½% annually during 1961-68 compared with 7.3% during 1951-60. Imports had been held down severely in the late 1950s and early 1960s because of balance-of-payments problems but grew very rapidly from 1962 to 1968 (see the chart) as investment rose above the stagnant levels

**Ecuador: Trade Trends**

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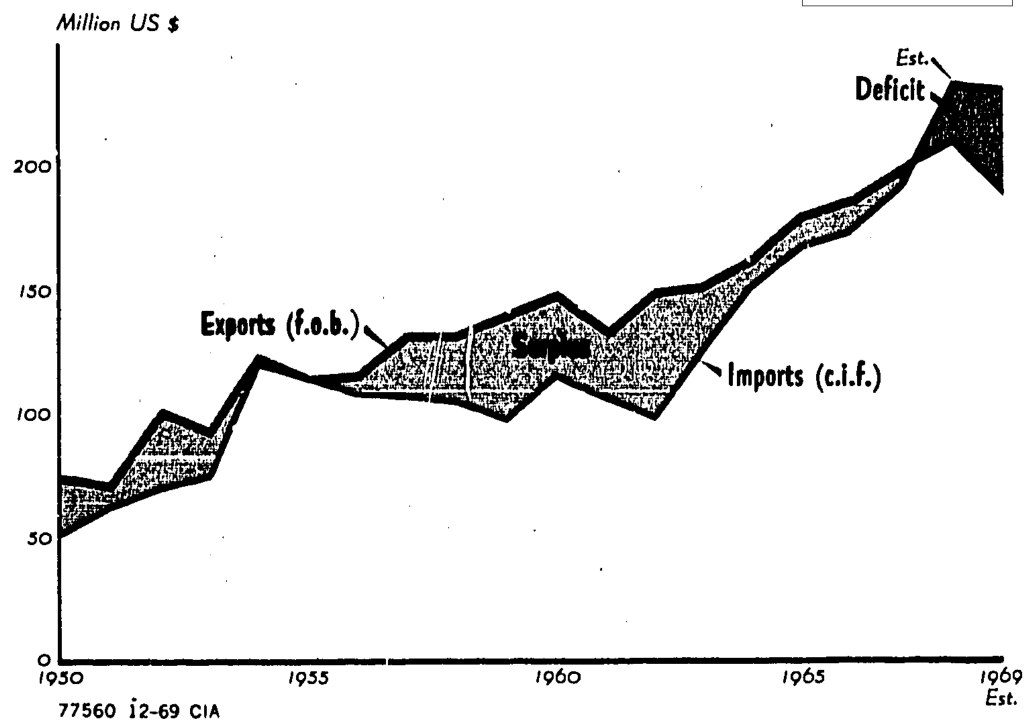


of the previous eight years. This expansion of imports and investment accelerated industrial development and contributed to a 5% growth rate for gross domestic product compared with 4% during 1956-62.

## Poor Outlook for Exports Through 1972

3. Ecuador's exports in 1969 are likely to have been about 10% below those of 1968 (see Table 1).

Table 1

Ecuador: Value of Exports

Million US $ (f.o.b.)

| Commodity | 1960 | 1965 | 1966 | 1967 | 1968 Pro-visional | 1969 Estimated |
|---|---|---|---|---|---|---|
| Bananas | 90 | 96 | 105 | 105 | 105 | 93 |
| Coffee | 22 | 38 | 32 | 40 | 34 | 31 |
| Cocoa | 21 | 19 | 17 | 25 | 39 | 32 |
| Fish products | 4 | 6 | 5 | 6 | 6 | 8 |
| Sugar | 1 | 7 | 6 | 8 | 8 | 9 |
| Other | 11 | 14 | 20 | 17 | 18 | 18 |
| *Total a/* | *149* | *181* | *186* | *200* | *210* | *191* |

*a. Because of rounding, components may not add to the totals shown.*

Cocoa sales fell because bad weather reduced the 1969 crop to only four-fifths of the record crop of 1968. The decline in coffee earnings was also caused by bad weather as well as by weakening world market prices. On the other hand, total earnings from other, "minor," exports -- principally fish products, sugar, and miscellaneous forest and agricultural products -- probably increased about 9% over 1968.

4. Earnings in 1970-72 have little prospect of recovering to the 1968 level, mainly because reduced shipments and price drops caused by greater competition are expected to depress banana earnings to about 75% of the 1968 level in 1970 and 70% in 1972. Recovery in cocoa and coffee shipments and substantial expansion of "minor" exports are expected, however, to offset some of the decline in banana sales. The favorable growth prospects of "minor"

exports reflect recent and prospective investments and the technical assistance being provided by international development agencies. Export projections for 1970 and 1972 are as follows:

| | Million US $ (f.o.b.) | | |
|---|---|---|---|
| | 1969 | 1970 | 1972 |
| Bananas | 93 | 80 | 75 |
| Coffee | 31 | 34 | 36 |
| Cocoa | 32 | 38 | 38 |
| Other | 35 | 42 | 51 |
| *Total* | *191* | *194* | *200* |

The Banana Problem

5. Increased competition from other banana producers has markedly eroded Ecuador's share of the world market since 1964 (see Table 2). The major drop occurred in sales to the United States and Canada, where it lost ground to the Central American countries. Ecuador's share of the Western European market also declined over the period, the principal gains being made there by the Central American countries.

6. The country's position as the world's largest banana exporter since the early 1950's does not reflect any unique advantages. Ecuador is free of hurricanes and has effectively controlled the Panama disease, whereas in the middle and late 1950s and early 1960s Central American banana plantations were decimated by disease and storms. Moreover, Taiwanese producers have suffered severe losses from typhoons in certain years. But Ecuador has the disadvantage of being farther from the major markets than are the other producers. Transport costs to the North American and Western European markets are lower for Central American than for Ecuadorean shipments, which generally must transit the Panama Canal and require at least three days longer. Central American producers also have the advantage of raising mainly the new Cavendish banana, which is more resistant

Table 2

Market Shares of the Principal Banana-Exporting Areas

Percent of Total

| | World | | | | | United States and Canada | | Western Europe a/ | | Japan | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Exporting Area | 1964 | 1965 | 1966 | 1967 | 1968 | 1964 | 1968 | 1964 | 1968 | 1964 | 1968 |
| Ecuador | 37 | 28 | 26 | 26 | 24 | 44 | 20 | 27 | 23 | 46 b/ | 39 b/ |
| Central America | 28 | 30 | 35 | 37 | 42 | 51 | 78 | 8 | 21 | 0 | 4 |
| Caribbean area | 15 | 17 | 16 | 14 | 9 | 3 | Negl. | 32 | 20 | 0 | 0 |
| Africa | 9 | 10 | 7 | 6 | 6 | 0 | 0 | 21 | 13 | 0 | 0 |
| Asia and other c/ | 11 | 15 | 16 | 16 | 19 | 2 | 2 | 12 | 23 | 54 | 57 |
| *Total* | *100* | *100* | *100* | *100* | *100* | *100* | *100* | *100* | *100* | *100* | *100* |

*a. Members of the OECD only.*
*b. These figures are abnormally high because storm damage reduced Taiwanese deliveries. Ecuador accounted for only 10%-17% of total banana exports to Japan during 1965-67.*
*c. Including principally Taiwan, the Philippines, Colombia, and the Surinam-Netherlands Antilles.*

to disease and storm damage, is more easily shipped, and permits higher yields per acre than does the Gros Michel, Ecuador's dominant variety.

7. Ecuador's attempts to promote its banana exports have had mixed success so far. In Western Europe, Quito has successfully pressed a few governments to increase their duty-free import quotas -- efforts that have benefited other producers as well. Ecuador also has sought to develop new markets in Eastern Europe through bilateral trade negotiations, but exports to this area made up only 4% of the total in 1968, in part because of Ecuador's own reluctance to import East European goods. This limitation on banana sales to the area seems likely to persist. Ecuador also is attempting to improve the quality of its bananas when they reach market and, belatedly, to accelerate conversion to the Cavendish variety.* Meanwhile, the country continues to benefit by making up crop losses sustained by other producing countries. For example, the drop in banana earnings in 1969 would have been greater if Ecuador had not been able, in September and October, to fill North American and Japanese orders prompted by storm damage to the Honduran and Taiwanese crops, respectively.

## The Promise of Petroleum Devlopment

8. Ecuador's best hope for regaining export momentum lies in exploitation of the petroleum deposits that a Texaco-Gulf consortium has discovered since 1967 in the northeastern jungles.** Because the consortium must build a costly pipeline to the Pacific Coast to market the oil, which will require large local expenditures, the balance of payments would benefit considerably even before early 1973, when oil exports could begin. Commencement of work on the pipeline was delayed

* *The Cavendish variety made up about 50% of Ecuadorean exports during January-September 1969 compared with 19% during January-July 1968. The government hopes to increase the share of the Cavendish in total banana acreage to 80% by 1973, if possible, and in any case by 1975.*

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during most of 1969 by government demands for a larger profit share, but the dispute has been resolved and the path now seems clear for construction to begin during the second half of 1970.

9. Foreign exchange receipts from petroleum development could be substantial during 1970-72, since purchases of Ecuadorean labor and goods probably would make up about one-third of the $250 million cost of further developing the oilfields and building a 320-mile pipeline to the port of Esmeraldas. Outlays in Ecuador should provide exchange receipts of some $19 million in 1970 and an average of about $29 million annually during 1971-72. By the mid-1970s, Ecuador is expected to be in a position to export about 150,000 barrels of crude oil daily, earning about $60 million annually (nearly 30% of total exports in 1968). These exports also would provide government revenues of at least $25 million -- an amount equal to about one-sixth of total revenues in 1968.

## Implications for the Balance of Payments

10. In early 1969 the Velasco government (which had taken office the previous September) faced the threat that declining exports would worsen the balance-of-payments problems that arose in 1968. Slackening export growth and a continuing steep rise in imports in 1968 generated a $24 million trade deficit -- the first deficit in 19 years. The net outflow for services raised the current account deficit to some $60 million. Although receipts of long-term capital were almost sufficient to cover this deficit, Ecuador lost some $8 million in short-term capital during 1968 because of the election turmoil and suffered a reduction in foreign exchange reserves from $69 million (an all-time high) to $57 million.

11. The government began to take countervailing measures during the first quarter of 1969, when reserves shrank by a further $8 million. It reduced imports slightly and extracted $5 million from the oil consortium in increased charges for land rights. But the export drop probably boosted the trade and current account deficits to some $40 million and $75 million, respectively. Ecuadorean

authorities could reasonably anticipate net capital receipts of only about $55 million -- $30 million of it from the United States and international institutions. These receipts were supplemented in midyear by pressuring the oil consortium into making a $6 million advance payment for petroleum royalties (which was regarded as an interest-free loan). In anticipation of a balance-of-payments gap, the government obtained an $18 million standby credit from the International Monetary Fund (IMF) in April and drew $12 million by August. Although Ecuador soon exceeded the agreed-upon limits for Central Bank credit to the government and became ineligible for further drawing, $6 million in "compensatory" financing was obtained from the IMF in October, in recognition of the sagging exports. Through these expedients, Ecuador apparently was able to avoid a further loss in reserves during 1969 and may have achieved a small gain.

12. Balance-of-payments strains will continue into 1970. As a result, the government may have to cut imports (excluding goods brought in for the oil industry) by $10 million or so, unless it can get more IMF credits or foreign aid or will accept a foreign exchange loss. If petroleum exploitation does not get under way, the difficulties will be greater. These strains probably will moderate in 1971-72, however, if outlays for oilfield development and pipeline construction rise as scheduled and the budget situation allows Ecuador to take full advantage of aid commitments from the United States and international financial institutions. Net aid receipts could in this case rise to some $40 million in 1972. Nevertheless, the government probably will have to continue import restrictions through 1972. If the petroleum project is delayed or interrupted, the government will face further difficult choices.

## The Budget Situation

13. Velasco faces budgetary as well as foreign payments difficulties. The government's financial situation was already precarious in September 1968 when he was inaugurated because the election campaign had prompted his predecessor to sharply increase public works spending and raise teachers'

salaries. While expenditures rose by 38% in 1968, revenues grew only by 7%. The result was a budget deficit of $44 million (24% of expenditures), whereas the budget had been almost in balance in 1967.

14. The budget situation deteriorated further during 1969. Congress approved a sizable expansion in government expenditures but refused to increase taxes. In addition, Velasco -- as a matter of political expediency -- granted unbudgeted pay increases to the armed forces and national police. Because of the increased spending for current operations, the government curtailed spending on road and school construction and other projects. Nevertheless, expenditures rose more rapidly than revenues, and the financial pinch was so severe that the government fell two to three months behind in paying soldiers, policemen, teachers, and other public employees. The budget deficit in 1969 is believed to have amounted to $55 million (25% of expenditures).

15. To help finance its deficit (as well as garner foreign exchange), the Velasco government tried, without success, to sell $70 million worth of bonds to Western European investors, the oil consortium, and the several small foreign-owned mining companies in Ecuador. These sales were handicapped by a law that keeps real interest rates on bonds below present world market levels. The government thus had to resort to Central Bank financing of its deficit. In some previous years the potentially inflationary effects of Central Bank financing of government deficits were allowed to dissipate through increased imports. Central Bank financing of more than half of the deficit in 1968, for example, which in turn led to a sharp increase in the money supply, was partly responsible for the 23% rise in imports. In 1969, however, import restrictions prompted by balance-of-payments strains blocked this process. Pressure on domestic prices is not yet severe, but the cost of living in Quito did rise at a 7½% annual rate during the first ten months of 1969 compared with 2½% during the same months in 1968. In Guayaquil (the largest city), prices rose at a 4% annual rate during the first ten months of 1969.

16. The budget dilemma will continue in 1970-72. Congress probably will continue to approve expenditure levels well in excess of revenues, and the government will lose support if it spends less. To hold its budget deficits to a more comfortable level of (say) 12%-15% of expenditures, the government would have to reduce total expenditures in 1970 and severely curtail their growth in succeeding years. This procedure probably would slow economic growth, boost unemployment, and add to public disorder and unrest. Alternatively, the government could allow further sizable increases in expenditures and finance the resulting large deficits with Central Bank credit and such funds as could be obtained from the oil consortium and other foreign sources. This approach might help to sustain employment and the economic growth rate, but it probably would generate strong inflationary pressures and intensify balance-of-payments difficulties.

## Political Implications

17. Ecuador's budget and export problems apparently are weakening President Velasco's political position, which was not particularly strong to begin with. Although he probably remains popular with a considerable share of the public, grumbling in the army and other elite circles is growing. [redacted] 25X1
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Velasco has been beset 25X1
by student riots and strikes involving teachers and other workers. At times these disturbances have threatened to get out of control. Moreover, cabinet turnover has been great, and Velasco is encountering increasing difficulty in obtaining replacements. Some of his difficulties resemble those that led to his ouster from the presidency three previous times.

18. Velasco's problems will increase in 1970, even if the oil investments proceed without disruption. Reduced public investment outlays and rising unemployment would dismay some of his supporters and add to student and labor unrest. But continued large budget deficits and accelerating inflation would also be unpopular. In any case,

continuing economic difficulties and political turmoil may persuade military and civilian opposition groups that Velasco is unable to govern the country effectively. There is also the danger that he will strike a nationalistic posture to throw his enemies off balance and consolidate his support. Indications already have appeared that the government may in the near future nationalize All America Cables and Radio, Inc., (a subsidiary of the US-owned International Telephone and Telegraph Company), which normally handles 70% of Ecuador's international cable traffic. If Velasco should follow a nationalistic course, petroleum exploitation -- and thus Ecuador's prospects of recovering in the mid-1970s from its present difficulties -- would be threatened.

## Conclusions

19. Ecuador's dominant position in the world banana market, won in the 1950s following production difficulties in other countries, is gradually being eroded by increasing competition from Central American and other growers. This competition slowed the growth of Ecuador's total export earnings during 1961-68, causing a drop of about 10% in 1969, and promises to hold them below the 1968 level for the next few years. The government avoided losing foreign exchange reserves in 1969 only by securing $18 million in IMF assistance and pressing the Texaco-Gulf consortium to make a special $11 million payment. Excessive government spending produced large budget deficits in 1968-69 that threaten Ecuador's traditional financial stability and make adjustment to reduced export levels more difficult. Unrest appears to be weakening President Velasco's position, and the possibility remains of his becoming more nationalistic or being replaced by a military junta, which might also be nationalistic.

20. The country's major hope for an expansion of exports and government revenues that would largely overcome its present difficulties lies in the exploitation of the oil deposits discovered

recently by a Texaco-Gulf consortium. Although petroleum exports and tax revenues probably cannot begin until 1973, outlays for Ecuadorean labor and goods needed to build a pipeline and further develop the oilfields would help the balance of payments and stimulate economic activity in 1971-72 if the project moves ahead as scheduled. On the other hand, if excessive profit demands, political attacks on foreign investments, or coups disrupt the petroleum development program, Ecuador faces worsening problems of sluggish growth, unemployment, inflation, and foreign exchange stringency.